JULY 9, 1984

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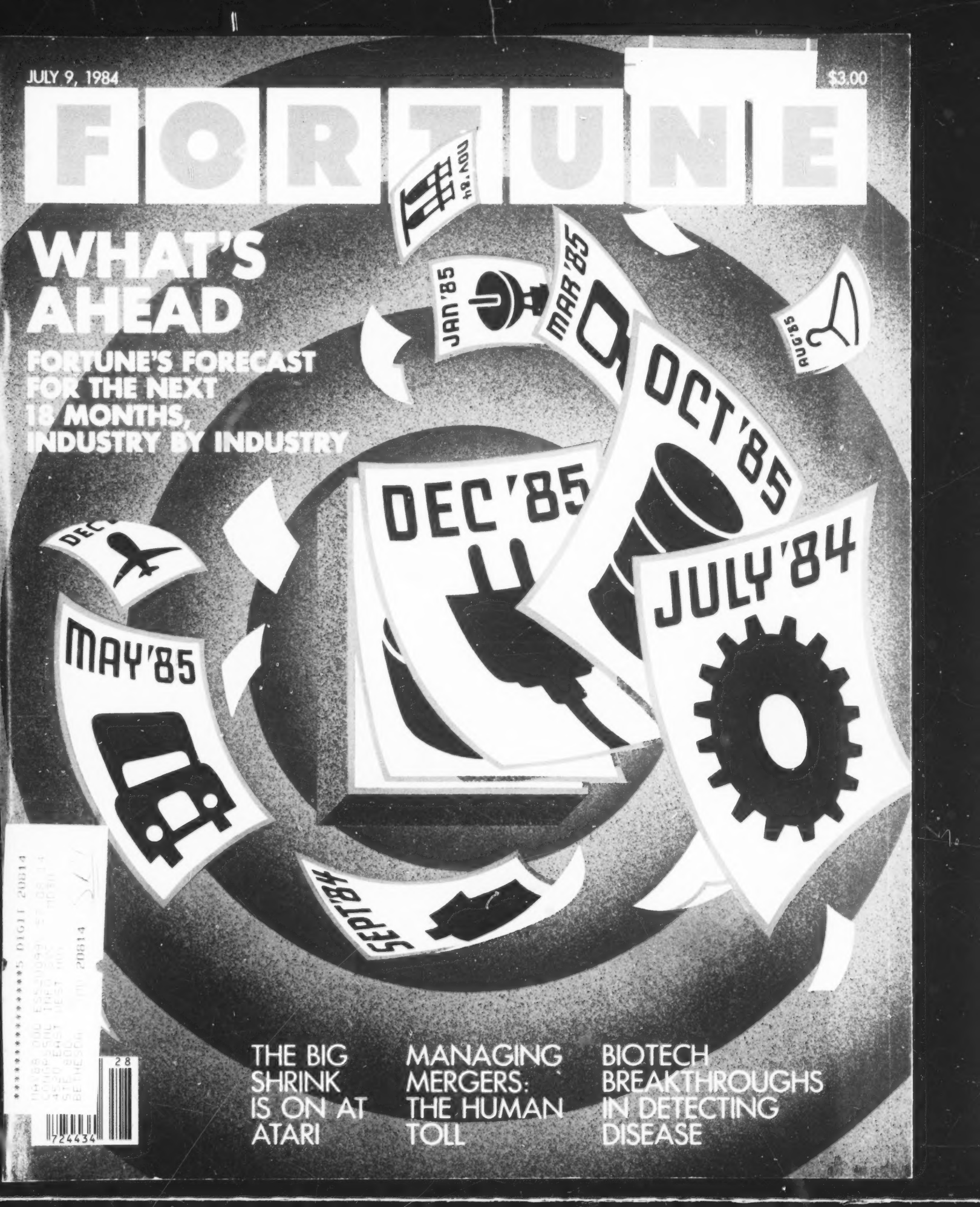
FORTUNE

WHAT'S AHEAD

FORTUNE'S FORECAST FOR THE NEXT 18 MONTHS, INDUSTRY BY INDUSTRY



THE BIG SHRINK IS ON AT ATARI

MANAGING MERGERS: THE HUMAN TOLL

BIOTECH BREAKTHROUGHS IN DETECTING DISEASE

JULY 9, 1984 VOL. 110, NO. 1

FORTUNE

How will major industries depicted in Michael Doret's cover illustration do over the next 18 months? FORTUNE's forecast is on page 12.

THE ECONOMY

Slower Growth Will Keep the Recovery Rolling 12
FORTUNE's forecast for the next 18 months.

CORPORATE PERFORMANCE

The Big Shrink Is On at Atari 23
Problems persist for the purveyor of Pac-Man, and the new boss has been forced to think small. *by Gary Hector*

InteCom: Breaking Out of a Niche Can Hurt 40

MANAGING

Help! My Company Has Just Been Taken Over 44
Minimizing employees' pain is not just compassionate, it may be crucial to making a merger work. *by Myron Magnet*

PRODUCING

Toyota Meets U.S. Auto Workers 54
How they get along is bound to have a profound effect on the future of U.S. labor relations. *by Michael Brody*

SELLING

Would You Buy Stocks Where You Buy Socks? 130
It's a tough sell, but the financial supermarkets want to persuade you it's not ridiculous. *by Geoffrey Colvin*

Glut and Gluttony in Mail Order 136

Computerized Bargain Hunting 137

TECHNOLOGY

Biotech Breakthroughs in Detecting Disease 140
New diagnostic kits on the market take out the guesswork. *by Gene Bylinsky*

MONEY & MARKETS

Citicorp After Wriston 146
The next chief's challenge: keep pushing into new fields and do better by the stockholders. *by Edward Boyer*

The Rush to Slow Bank Deregulation 152

How Goldman Sachs Grew and Grew 155
Doing business the old-fashioned way—as a partnership—has made it the No. 1 private Wall Street firm. *by Irwin Ross*

POLITICS & POLICY

Scoring Corporate Conduct in South Africa 168
Living up to the Sullivan principles isn't easy. *by Stratford P. Sherman*

Showdown for Reagan at Gender Gap 177

Synfuels Foiled 177

Turnabout at the FDIC 178

PROFILE

John Sculley Rises in the West 180
An Eastern Establishment marketer in Silicon Valley is putting a shine on Apple Computer. *by Joel Dreyfuss*

People to Watch 184

The Editor's Desk 2

News/Trends 4
The greenmailing of America, Argentine poker, the courting of Conrail, new chief at Merrill Lynch, video zooms, decline of the diesel car, and more.

Follow-Up 7
The trustbusters' new guidelines, more trouble for Johnson & Johnson, Lear Fan stalls, J. Fred Boyd is 100.

Letters to Fortune 9

Keeping Up 189
by Daniel Seligman

Personal Investing 197
Profiting from buybacks. McGraw-Hill. Defense stocks. Portfolio Talk: investment manager Robert Gintel.
by Elizabeth S. Silverman

On Your Own Time 207
Auto rallying comes back.
by Marilyn Wellemeyer

Books & Ideas 215
Economists can talk straight.
by David R. Henderson

BY ELIZABETH S. SILVERMAN

PROFITS FROM STOCK BUY-BACKS

The gains shareholders can enjoy when companies repurchase shares are worth watching out for.

■ This year's faltering stock market may have frightened away some erstwhile shareholders, but one class of investors is buying stock with a vengeance. Through May, reports Salomon Brothers, corporations had repurchased some 110 million shares of their own stock vs. 142 million shares in all of 1983, and they had announced plans to buy back another 169 million shares. The repurchases will cost over $12 billion, including the $1.74 billion **Teledyne** will shell out in the richest tender offer to date by a company for its own stock. **Standard Oil of Indiana** could exceed that sum a bit if it carries out plans to buy a tenth of its shares on the open market.

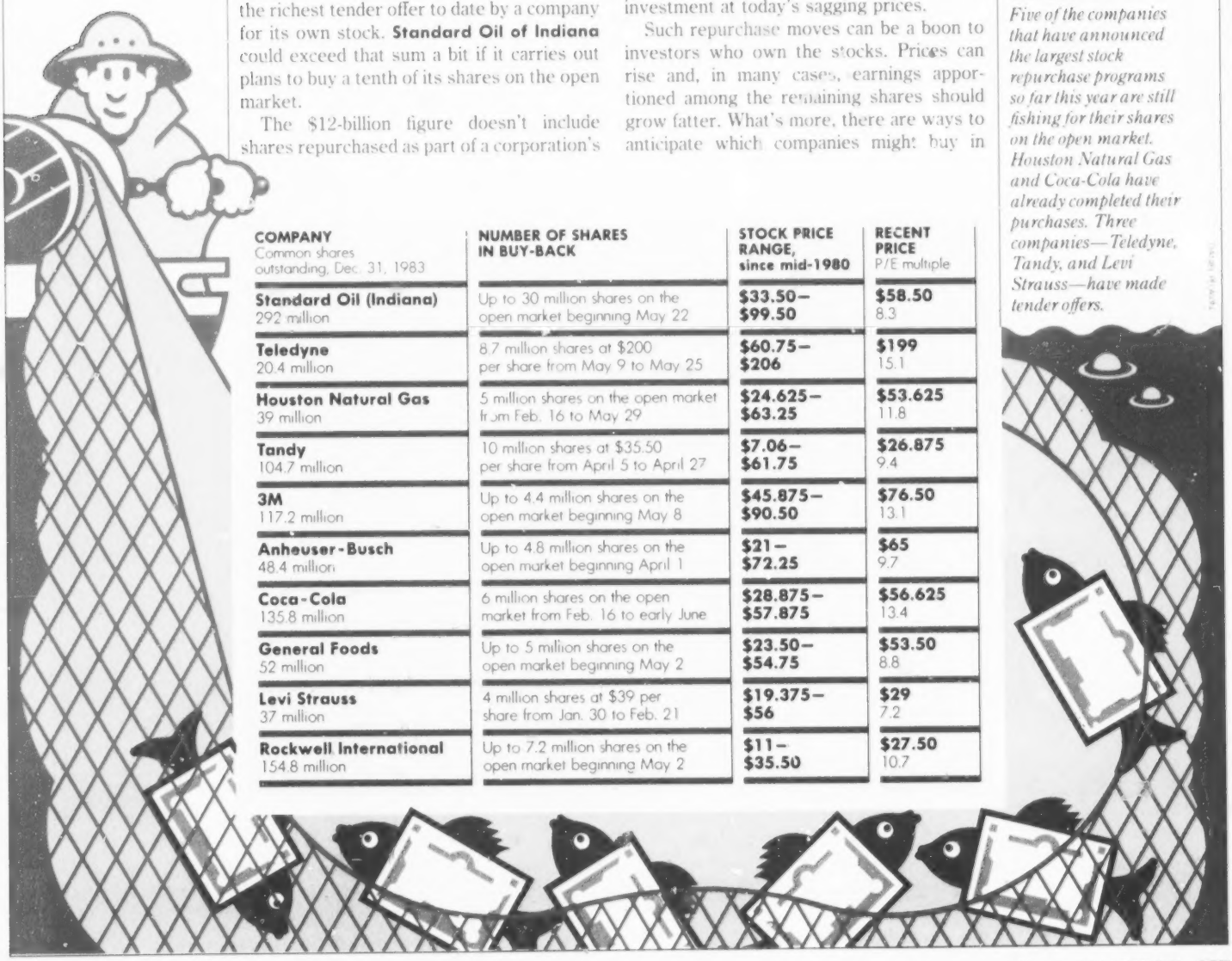
The $12-billion figure doesn't include shares repurchased as part of a corporation's defense against a takeover, as in the case of **Carter Hawley Hale Stores** in its battle with **Limited Inc.** It also excludes greenmail—shares repurchased at a premium from takeover artists. On the other hand, it includes shares bought more or less routinely by companies that periodically need stock for executive options and employee stock ownership plans. But a far larger portion represents shares that companies are buying because management believes they're a superb investment at today's sagging prices.

Such repurchase moves can be a boon to investors who own the stocks. Prices can rise and, in many cases, earnings apportioned among the remaining shares should grow fatter. What's more, there are ways to anticipate which companies might buy in

COMPANY Common shares outstanding, Dec. 31, 1983	NUMBER OF SHARES IN BUY-BACK	STOCK PRICE RANGE, since mid-1980	RECENT PRICE P/E multiple
Standard Oil (Indiana) 292 million	Up to 30 million shares on the open market beginning May 22	**$33.50–$99.50**	**$58.50** 8.3
Teledyne 20.4 million	8.7 million shares at $200 per share from May 9 to May 25	**$60.75–$206**	**$199** 15.1
Houston Natural Gas 39 million	5 million shares on the open market from Feb. 16 to May 29	**$24.625–$63.25**	**$53.625** 11.8
Tandy 104.7 million	10 million shares at $35.50 per share from April 5 to April 27	**$7.06–$61.75**	**$26.875** 9.4
3M 117.2 million	Up to 4.4 million shares on the open market beginning May 8	**$45.875–$90.50**	**$76.50** 13.1
Anheuser-Busch 48.4 million	Up to 4.8 million shares on the open market beginning April 1	**$21–$72.25**	**$65** 9.7
Coca-Cola 135.8 million	6 million shares on the open market from Feb. 16 to early June	**$28.875–$57.875**	**$56.625** 13.4
General Foods 52 million	Up to 5 million shares on the open market beginning May 2	**$23.50–$54.75**	**$53.50** 8.8
Levi Strauss 37 million	4 million shares at $39 per share from Jan. 30 to Feb. 21	**$19.375–$56**	**$29** 7.2
Rockwell International 154.8 million	Up to 7.2 million shares on the open market beginning May 2	**$11–$35.50**	**$27.50** 10.7

Hauling Them In

Five of the companies that have announced the largest stock repurchase programs so far this year are still fishing for their shares on the open market. Houston Natural Gas and Coca-Cola have already completed their purchases. Three companies—Teledyne, Tandy, and Levi Strauss—have made tender offers.



stock—a consideration that could sway a decision to invest in the companies.

Thanks to the 1982 tax act and the recovery, corporations are rolling in cash to finance repurchases. In earlier periods—the 1970s for example—many cash-rich companies used their newfound wealth to diversify, and a purchase of the company's own stock was thought wasteful. But today, says Samuel Karetsky of Morgan Stanley, who helps companies carry out buy-backs, "stock repurchase is viewed as a legitimate corporate finance technique."

THE OVERWHELMING majority of stock repurchase programs are carried out on the open market. If the stock is not undervalued, says Walker Lewis of the Washington consulting firm Strategic Planning Associates, a repurchase may have no effect on earnings per share. The number of shares outstanding decreases, but earnings shrink because the company loses the investment income on funds used to buy in the shares.

But Lewis adds, "Stock repurchases are almost always a good deal for the investor." Corporations tend to repurchase their own stock only when its price is low, he says. If it's selling at a price-earnings multiple of, say, five, adds Michael Sherman, head of investment policy at Shearson Lehman/American Express, the effective return is a whopping 20%. If the dividend yield is high, the company can also save more on dividend payments than it loses in investment income. Moreover, notes James McTaggart of the San Francisco consulting firm Marakon Associates, a stock repurchase should result in tax savings. When cash is held by a corporation, both the corporation and the shareholders who receive dividends are taxed on the income the cash earns. If excess cash is disbursed to the shareholders in a stock repurchase program, however, one layer of taxation—the corporate income tax—is avoided.

It's too early to say what effect this year's share repurchases will have on these corporations' stock prices. But Larry Dann of the University of Chicago looked at the repurchases of the 1970s and found that those done on the open market resulted in a 3% increase in the price of the stock, relative to the market. The higher price persisted for at least six months. Shareholders of companies that tendered for their stock fared even better. Those stock prices jumped, on average, 15% when the tender offer was announced, and stayed higher.

Steven Einhorn, an investment strategist at Goldman Sachs, has come up with a list of criteria for spotting corporations likely to repurchase their own stock. First and foremost, he says, these companies generate significant amounts of spare cash. Many repurchasers, such as Rockwell and 3M, also have exceptionally low debt as a proportion of total capital. Five of the ten repurchasers shown on the previous page have P/E multiples below the current market average, a common trait of repurchasers.

The stocks of companies likely to repurchase their own shares, says Einhorn, tend to be heavily owned by individuals, not institutions. Often, as in the case of Standard Oil of Indiana, these companies have made a number of large divestitures over the last few years. For this and other reasons, they tend to have lots of cash per share on their balance sheets. Many companies in the food, tobacco, soft drink, retailing, drug, chemical, energy, and cosmetics industries, as well as conglomerates, Einhorn says, have these attributes.

RESEARCH ASSOCIATE: *Margaret A. Elliott*

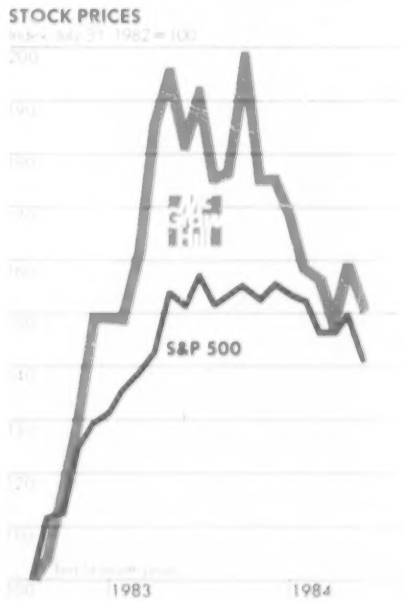
A Stake in the Information Boom

■ Shareholders of **McGraw-Hill**, the $1.3-billion-a-year New York publisher, are not accustomed to air pockets. The stock began a long climb a decade ago, only to stall in April 1983, along with that of other publishing companies. Its recent price of $39.25 a share, down 27% from its 12-month high, is far from cheap. At a price-earnings multiple of 13.5 times estimated earnings for this year, McGraw-Hill sells at a premium compared with Standard & Poor's 500-stock index. Yet analysts believe that the company's projected 15% to 17% annual earnings growth rate more than justifies that P/E. Says security analyst John Bauer of Oppenheimer & Co.: "For the growth you're getting, it is a good deal."

The cornerstone of McGraw-Hill, the publications division, puts out over 80 business, professional, and technical periodicals. Slightly larger, accounting for over $400 million in revenues last year, is the McGraw-Hill Book Co., the world's foremost textbook publisher. The company's fastest-growing operations, though, are those that use both print and electronic media to transmit information. Dodge Reports and Sweet's Catalog Files, two McGraw-Hill units that churn out definitive data on the construction industry, show perennially strong earnings gains. Standard & Poor's, a leading provider of financial information to the investment community, is the company's fastest-rising star. Its 48% increase in profits last year came on the heels of a 38% jump in 1982.

McGraw-Hill's forte, says Kevin Grunreich of First Boston, is information leverage, the process of creating new products using data bases and distribution channels already in place. MarketScope, an electronic service that provides stockbrokers with synopses of S&P research reports on individual companies, is a new offering that takes advantage of available resources. Even McGraw-Hill's traditional businesses are getting into the act. Its book division is just now introducing a combination of software and print materials for classroom use.

The key to success in the information-processing business, says analyst Patrick O'Donnell of Donaldson Lufkin & Jenrette, "is to pay once for a piece of information and



Giving Back the Gains

When the bull market got under way, McGraw-Hill's stock roared ahead, but it has been losing ground during most of the last 12 months.

to sell it as many times as possible without relinquishing it." McGraw-Hill's ability to do just that leads Kendrick Noble of Paine Webber to term its stock "one of the best in the publishing industry."

Defense Stocks After the Big Retreat

■ Defense stocks are suffering from combat wounds. Most aerospace issues are selling at less than eight times estimated earnings for 1984. Military electronics stocks command higher price-earnings multiples, but sell at a discount to stocks of other high-tech companies with similar earnings prospects. Worries that the huge federal deficit would force big cuts in the defense budget, combined with uncertainty over the outcome of this November's presidential election, shot these former high-fliers down in mid-1983.

What investors are just beginning to realize, says Gary Reich of Wertheim & Co., is that "when politicians call for defense cuts, they are not calling for declines in defense spending so much as for a cut in the President's requested increase." Indeed, most observers now expect Congress to approve a 1985 defense budget allowing for 5% real growth. What's more, says Robert Kugel of Morgan Stanley, "the fundamentals of these stocks will remain strong throughout the 1980s, almost irrespective of who is elected President in November."

The fundamentals, in fact, are considerably more impressive than are those of most industries. Analysts foresee earnings gains of around 20% this year and 30% in 1985. Because of the long lead time on most weapons programs, any slowing of the growth in the defense budget would not be felt for several years at least. And as Wolfgang Demisch of First Boston points out, defense stocks are practically immune to a recession.

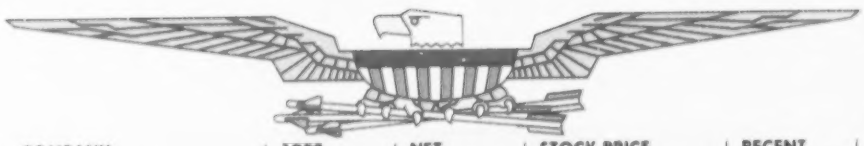
General Dynamics, biggest of the pure-play defense stocks, makes "planes for the Air Force, subs for the Navy, tanks for the Army, and missiles for everyone," says Reich of Wertheim & Co., and the St. Louis-based company's major military contracts are still in their early stages. Unfavorable publicity has hurt the stock. A former executive, accused of taking kickbacks on commercial business, fled the country and has recently alleged that General Dynamics chiseled on some Navy submarine contracts. Though the company denies this, the stock's multiple—just 6.7 times the $7.20 earnings per share that Reich expects this year—is one of the lowest in the industry.

Larger than General Dynamics, though not pure defense plays, are **Boeing** and **McDonnell Douglas**. Because Boeing derives only a third of its revenues from military sales, its fortunes to a great degree depend upon the health of commercial airlines—its main customers. The Seattle company's stock has also been selling at a higher P/E than the other aerospace shares. Nevertheless, expectations that the world's airlines will go on another plane-buying binge sometime in the next few years have propelled Boeing onto several buy lists. St. Louis-based McDonnell Douglas, by contrast, is primarily a defense contractor turning out such big-ticket items as the F-15 fighter.

Lockheed and **Northrop** are favorites of Paul Nisbet of Prudential-Bache. Saved from bankruptcy by a federal loan guarantee 14 years ago, Lockheed has grown financially strong enough to resume paying a cash dividend. Nisbet projects that the Burbank, California, company's earnings per share will climb by 33% this year and another 23% in 1985. Northrop's earnings will grow even faster, says Nisbet—by over 50% both this year and next.

More expensive, but not excessively so in the view of many analysts, are the stocks of several military electronics concerns. These companies' profits, says Peter Aseritis of E.F. Hutton, would suffer less than those of the aerospace manufacturers if Congress actually did cut back on defense spending. If budgets were tight, explains Aseritis, the military could modernize old airplanes by stuffing them with state-of-the-art electronics. **Loral**, the leader in electronic countermeasures, is one of his picks. The New York City company just posted a 25% earnings-per-share gain for the fiscal year that ended March 31, and Aseritis expects a similar showing in the current fiscal year.

Watkins-Johnson, says Alan Benasuli of Drexel Burnham Lambert, "has both a wealth of proprietary technology and a sound balance sheet." The company, based in Palo Alto, is a major supplier of top-secret surveillance systems and components. Benasuli projects earnings-per-share growth of 27% this year, followed by 18% to 20% climbs in 1985 and 1986. **Sanders Associates** of Nashua, New Hampshire, sells electronic warfare systems to the government and computer graphics equipment to corporations. Michael Carstens of Becker Paribas expects earnings from government sales—two-thirds of Sanders's total—to grow by 30% to 35% annually through 1987.



COMPANY	1983 REVENUES in millions	NET INCOME in millions	STOCK PRICE RANGE last 12 months	RECENT PRICE P/E multiple
Boeing	$11,129.0	$355.0	$35.625–$49.875	$40.875 11.5
McDonnell Douglas	$ 8,111.0	$274.9	$46.125–$62	$54.25 7.6
General Dynamics	$ 7,146.3	$286.6	$42–$61.75	$48 8.3
Lockheed	$ 6,490.3	$262.8	$30.125–$47.50	$35.25 8.1
Northrop	$ 3,260.6	$100.7	$71–$98.125	$85 10.4
Sanders Associates[1]	$ 578.1	$ 37.0	$35.25–$61	$40.25 19.4
Loral[2]	$ 418.3	$ 33.9	$18.50–$30.50	$22.75 15.7
Watkins-Johnson	$ 186.0	$ 17.7	$18–$30.625	$23.625 12.2

[1]Figures are for fiscal year ended July 29, 1983. [2]Figures are for fiscal year ended March 31, 1984.

Battle-Scarred Stocks of Pentagon Suppliers

Budget uncertainties have left some of these defense stocks with low price-earnings multiples despite the companies' good earnings prospects. Others sport fancy double-digit P/Es, but analysts expect their earnings to swell by 25% or so annually for several years.